Internal Revenue Service

memorandum

CC:TL-N-9634-90
Brl:VLDraper

date: SEP 5 1990

to: District Counsel, Phoenix CC:PNX

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: [redacted]

This is in response to your memorandum of August 14, 1990, requesting tax litigation advice on the above-referenced subject.

ISSUE

Whether it is appropriate to apply I.R.C. § 464 to limit current deductions associated with the purchase of embryos and semen and the rental of cows for cattle breeding purposes.
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CONCLUSION

Section 464 is applicable to limit the deductibility of costs associated with the cattle breeding process.

FACTS

[redacted] is a TEFRA partnership which claims to have purchased [redacted] cattle embryos that it had implanted into recipient cows. The partnership's stated goal was to produce superior progeny from these embryos and sell the progeny at a profit. The partnership agrees that if it is found to be in the trade or business of farming, then it qualifies as a farming syndicate.

In [redacted] the partnership entered into a contract with [redacted] ([redacted]) to purchase the cattle embryos. The agreement provided that [redacted] would lease the recipient cows and provide services to the partnership for purposes of breeding and reproducing the cattle. Under the purchase plan selected by the partnership, there was no guarantee of any sort provided by [redacted] as to the pregnancy or birth.

The total cost for the embryo was $[redacted], broken down as follows:

$[redacted]--recipient cycle and preparation
[redacted]--recipient use cost

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[redacted]--embryo
[redacted]--semen
$[redacted]

The partnership claimed each of the four components of the $[redacted] total as a separate expense on its [redacted] and [redacted] income tax returns. The Service has taken the position (1) that each of the four components is allowable as a deduction only to the extent consumed each year, (2) questions whether rental costs should be similarly limited, and (3) has not limited other costs such as transportation of the recipient cows.

DISCUSSION

Section 162(a) allows as a business expense all the ordinary and necessary amounts paid or incurred during the taxable year in carrying on any trade or business. Treas. Reg. § 1.162-12(a) allows a farmer to deduct as an expense the cost of feed and other items related to raising livestock.

Section 464(a) provides that in the case of any farming syndicate, a deduction otherwise allowable for amounts paid for feed, seed, fertilizer or other similar farm supplies shall only be allowed in the taxable year in which such feed, seed, fertilizer or other supplies are actually used or consumed, or, if later, in the taxable year for which they are allowable as a deduction without regard to this section. Section 464(e) defines "farming" to mean, inter alia, the raising or harvesting of any agricultural commodity, including the raising and management of animals.

The legislative history of this statute makes it clear that the statute was intended to prevent farm syndicates from benefitting from deductions otherwise allowed to farmers in order to defer taxes on nonfarm income. For this reason, farming was defined broadly. S. Rep. No. 94-938, 94th Cong., 2d Sess. 60-61 (1976). In addition to other types of deferral shelters at which the statute was aimed, Congress specifically mentioned livestock breeding shelters. Id. at 57. With regard to these shelters, Congress mentioned, inter alia, preventing the deduction of prepaid expenses in addition to the expenses of raising young animals.

Based on the language of section 464 and its legislative history, application of the statute to the facts in this case is supported by both the letter and the spirit of the law. First, the literal language of the statute applies.

Webster's Ninth New Collegiate Dictionary defines "seed" as, inter alia, "a propagative animal structure:...semen...a small egg...." Seed, whether animal or vegetable , is for the propogation of new life. Therefore, the material at issue is specifically covered by the term, "seed," as used in the statute.

Second, even if Congress was not thinking of the term, "seed," in the biblical sense of semen, or "fertilizer" in the biological sense of semen (in which context, the embryo would become the seed), given that one intent of the statute was to prevent farming syndicates from benefitting from prepaid expenses in connection with breeding operations, the language of section 464 "or other similar farm supplies" is broad enough to cover them. It would defeat the purpose of Congress to cover breeding operations in section 464 if it were to be held that the statute only applies to the components that produce plants and not the components that produce animals. Consequently, to the extent the Service can show that only so much of the expenditure for these items was used or consumed in the taxable year, the deduction for these expenditures can be limited to that amount.

Section 464 can also be applied to limit the current deductibility of the rentals of the recipient cows. Such expenditures, except for the limitations of section 464, would be current deductions associated with breeding operations. Section 162(a)(3); Treas. Reg. § 1.162-12. As the statute was intended to prevent the deduction of prepaid expenses in connection with such operations, it would also apply to these current deductions for rental expenses.

If you have any questions on the above, please contact Virginia L. Draper at FTS 566-3521.

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